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TAGS: [EFIN](#) [ECON](#) [PGOV](#) [HK](#) [CH](#)
SUBJECT: HONG KONG DOLLAR PEG'S FUTURE UNDER CONSIDERATION
BY GOVERNMENT ADVISORY BODY

REF: A. 05 HONG KONG 1465
[1](#)B. 05 HONG KONG 2512

Classified By: EP Section Chief Simon Schuchat; Reasons: 1.4 (b/d)

SUMMARY/COMMENT

[1](#)1. (C) The Chinese renminbi (RMB, 8.02=1 USD) and Hong Kong dollar (HKD, 7.76=1 USD) are likely to reach parity by year-end, assuming the RMB continues its gradual appreciation in line with most forecasts. Looking at the evolution of the two currencies, such parity would merely be an accident of history. However, considering Hong Kong's increasing economic integration with the mainland, the RMB becoming a dearer currency than the HKD is likely to spark widespread discussion here of scrapping the HKD-USD peg, not to mention much speculative activity against the HKD. One financial contact told us that the conversation about the future of the peg has already begun within a Hong Kong Government (HKG) advisory committee that he sits on. Local analysts with two of Hong Kong's paper currency-issuing banks, HSBC and Standard Chartered, doubt that change is coming within the next three years, but our HSBC contact said that there is a growing view within his organization that the HKD-USD peg should be re-examined in light of Hong Kong's growing role as a financial intermediary for mainland China. Given the emphasis that Hong Kong places on maintaining its reputation as a stable and well-run international finance center, we anticipate that any move off the peg would occur only after a minimum of several years of discussion and debate. During the ensuing period, however, neutralizing speculative activity could very well become an ongoing headache for the HKMA. END SUMMARY/COMMENT

QUESTIONING THE PEG

[1](#)2. (SBU) Hong Kong has currency autonomy under "one country, two systems." The link between the HKD and USD dates to October 1983. At that time, the British colonial government responded to currency instability associated with uncertainty over Hong Kong's future under Chinese rule by instituting a link -- not technically a "peg" but generally referred to as such -- between the HKD and the USD. The value of the fully convertible HKD is maintained through a currency board, i.e., a system that ensures all issued currency is fully backed by reserves of USD. (See Ref A)

[1](#)3. (C) DBS Bank Managing Director Andrew Fung is among 153

members of the HKG's Commission on Strategic Development, an entity that advises the Chief Executive (CE) on Hong Kong's long-term needs and goals. Fung told us that commission members are actively discussing and submitting papers on the future of the HKD-USD peg. Numerous commission members who, in Fung's words, "have the ear of senior officials" are arguing that the HKD-USD peg should be floated shortly after the Chinese renminbi (RMB) surpasses the HKD in value. The RMB presently trades at 8.02 to the USD; the HKD is maintained within a small band centered at 7.80 to the USD. Conventional wisdom among currency watchers is that the RMB will appreciate at least 3 percent during the remainder of 2006, thus putting it at or beyond parity with the HKD within the next nine months.

14. (C) Fung asserted that once the RMB appreciated beyond parity, speculators would assume the HKD would rise along with it, creating overwhelming market pressure. If the Hong Kong Monetary Authority (HKMA) then maintained the HKD-USD peg, the result would be stock market and property bubbles as speculators chased assets denominated in HKD, hoping to make a profit once the peg was broken. The speculative inflows would also create unwelcome interest rate volatility for property-focused Hong Kong, in Fung's view.

POLITICALLY SENSITIVE

15. (C) Fung predicted that CE Donald Tsang would not go along with breaking the peg before the next CE election in 2007. The prospect of a float would be highly unsettling to Hong Kong savings account holders who often out of habit hold USD, Australian dollar, or New Zealand dollar accounts as a hedge against what for many years has been a fear of a HKD

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devaluation (currently unwarranted). It would also hurt leading businesses whose holdings tend to be invested in USD instruments on the assumption of a stable USD-HKD peg.

16. (C) Fung said that Hong Kong's economy is now much more closely tied to that of the mainland rather than the U.S. Although it is not technically feasible to peg to the RMB (a non-convertible currency), any floating of the HKD would lead to its closely tracking the RMB's value. Speculators know this and would start to get very excited about the prospect of the peg being broken once the RMB hit 7.5 to the USD, Fung predicted.

VIEWS FROM TWO CURRENCY-ISSUING BANKS

17. (C) Standard Chartered Bank Global Research Economist Tai Hui predicted no change in the HKD-USD peg for at least three years. He assessed HKMA as very capable of fighting speculators through reserves and sterilization measures. Any float would create confidence issues for the HKD. HSBC Senior China Economist Hongbin Qu said the HKD-USD peg would likely hold for at least several years. He said that HSBC -- like Standard Chartered, an issuer of HKD paper currency -- does not publicly discuss the peg; however, there is a growing internal view that Hong Kong should rethink its currency tie to the USD. Qu explained that if Hong Kong is to build upon its growing role as China's center for financial intermediation, it needs a currency more closely linked to the mainland, not to the U.S.

ISSUE KEEPS REARING ITS HEAD

18. (SBU) On May 18, 2005, the HKMA tweaked its currency policy for the first time since the 1998 Asian Financial Crisis, hoping to prompt speculators to reduce reliance on the Hong Kong dollar (HKD) as a proxy currency for anticipated Chinese renminbi (RMB) revaluation. The introduction of a 0.6 percent trading band around a linked

rate of 7.80 to the USD -- replacing what was a one-way depreciation floor -- suggested that HKMA viewed distortions to Hong Kong's financial system caused by RMB speculation as a significant and enduring economic challenge that could potentially worsen as China took steps to introduce RMB flexibility. The change made it riskier for speculators to maintain positions using the HKD and seems to have worked. However, our contacts all pointed out that any significant and growing variance between the HKD and a stronger RMB would still likely invite speculation against the USD-HKD peg. (See Ref B)
Cunningham